

Smarter Bear 2026 Outlook

As we look ahead to 2026, one of the most popular topics among analysts and prognosticators is: “Are Artificial Intelligence investments a bubble, like the Dot-Com Bubble of 1999-2000?” We’re not going to spend any ink on that question because we genuinely believe that it’s a ‘Fool’s errand’; the answer is unknowable until after the fact.



However, there are many other topics to cover along with the supporting data. We will also avoid getting entangled in political questions. We are focused on policy, economics, and markets.

We’d like to thank and credit JP Morgan Asset Management, Bloomberg, Reuters, the St. Louis Federal Reserve, and Apollo Global Management for providing several of the charts and graphs.

This paper is organized into three sections:

Tailwinds:

- Artificial Intelligence/Data Center Capital Investments
- AI Productivity Gains
- The “One Big Beautiful Bill Act” positive economic impacts
- Index investing and Target Date funds
- Dollar depreciation and falling oil prices

Headwinds:

- Trade and Tariff uncertainty
- Immigration restrictions and (skilled) labor shortages
- Federal Reserve independence and inflation
- Student loan payments restarting
- Elevated Large Cap Company valuations
- Fiscal situation
- Geopolitical risks

Financial industry trends:

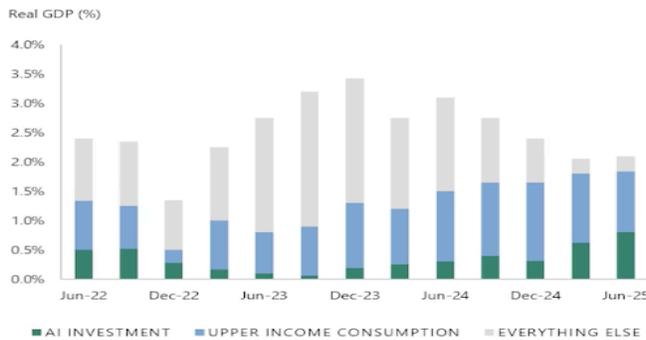
- Sales of Annuities
- Many new types of ETFs
- Private Equity and Private Debt offerings to the public

Tailwinds:

Artificial Intelligence/Data Center Capital Investments

Investments in Data Center construction, AI chips, servers, network gear, and the required electrical power infrastructure are the primary drivers of recent U.S. economic growth.

AI Investment and High-Income Spending Supporting Growth

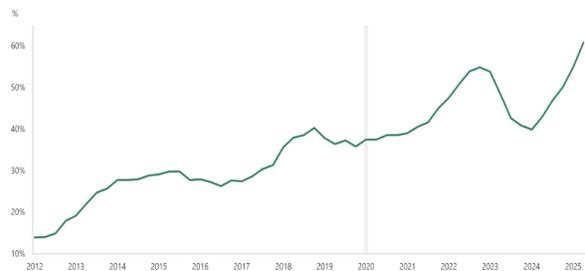


Growth in spending is increasingly coming from AI and high-income consumers. This is a significant change from 18 months ago. While this is currently a tailwind, if either slows, the economic impact will be substantial. While there is broad agreement that Artificial Intelligence will positively impact productivity, questions remain about when the revenue and profits will be achieved, and which companies will be the winners and losers.

The Hyperscalers (Alphabet/Google, Microsoft, Amazon, Meta), have had the cash flow to sustain their AI infrastructure spending, however you can see the increasing burden. Other players are being stretched to keep pace. Recently, Oracle and CoreWeave have declined in value due to concerns about their debt levels and the uncertainty around future revenue.

Capex Share of Operating Cash Flow for Hyperscalers: 60%

Amazon, Google, Microsoft, Meta and Oracle (hyperscalers) capital expenditures as a percentage of operating cash flow



Nonresidential structures investment

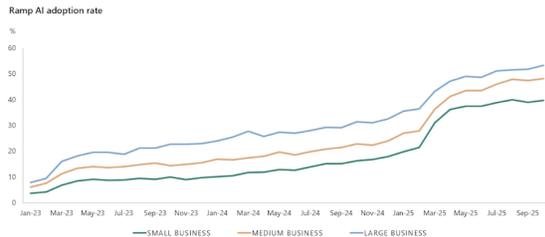


Finally, and perhaps as a result, while there continue to be announced plans for further large-scale data center investments, the rate of growth has slowed.

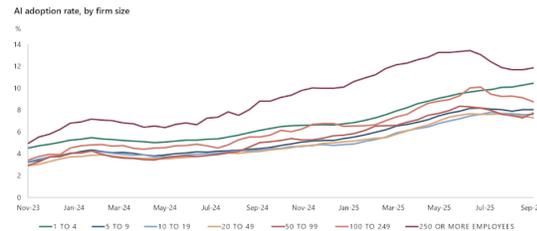
AI Productivity Gains

There are some early signs that AI will boost productivity. There is hope and expectation for much more in the long term. While hyperscalers and AI model builders are making substantial investments, we observe more conservative adoption, and this pattern is likely due to companies/customers waiting for the technology to improve and be adapted to more real-world business use cases.

AI Adoption Rates Starting to Flatten Out Across All Firm Sizes



AI Adoption Rates Starting to Flatten Out Across All Firm Sizes (cont'd)



The One Big Beautiful Bill Act's positive impacts.

The Committee for a Responsible Budget (CRB), a well-respected, nonpartisan organization, predicts that OBBBA will increase economic growth by 0.7% in 2026. OBBBA includes over 100 changes to the tax code - some notable items that support the stronger growth include:

- \$6000 per senior "bonus" deduction
- No taxes on overtime
- No tax on Tips
- Higher Standard Deduction
- Increased limits on State and Local Tax deduction
- Enhanced Qualified Business Income credit
- Accelerated depreciation for business investments

Each of these provisions has limitations, but for eligible individuals, they should increase income, which will affect consumer and business spending and growth. CRB, along with other respected, nonpartisan organizations such as the Tax Policy Center and the Yale Budget Lab, agrees that the economic boost will be short-lived.

Index investing and Target Date funds

A few data points:

- The value of the entire U.S. stock market fluctuates between \$60 and \$70 trillion.
- 80% of the total Stock market valuation is represented by the S&P 500.
- Target Date Funds (TDFs) and Index Investing are tightly linked. 30-40% of TDF assets are in S&P 500 index funds.
- The top 6 S&P 500 and Total Market index funds hold \$5.1T in assets
- According to a projection from Cerulli Associates, a market research firm, by 2027 target-date funds will account for roughly 66% of all 401(k) contributions, and about 46% of total 401(k) assets will be in TDFs.

- The Investment Company Institute estimates that the total value of all Defined Contribution Plans (401(k)s, 403(b)s, and IRAs) in the U.S. is approximately \$31 trillion, with about 55% in stocks.

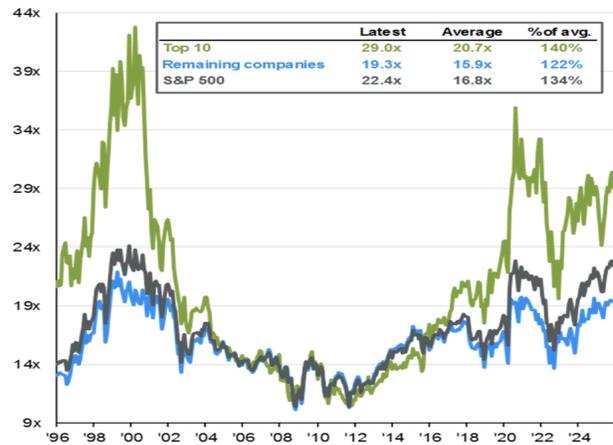
The Top 10 stocks in the S&P 500 now make up almost 40% of the S&P 500²



Lots of numbers here, but the point is that a significant amount of investment is on autopilot - buying the TDFs and S&P 500 index funds every month. The S&P 500, a market-capitalization-weighted index, is dominated by the 10 largest stocks.

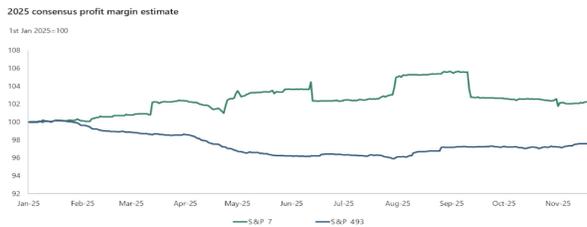
The size of TDFs and S&P 500 index funds, and the monthly dollar flows into these funds, reinforce the dominance of the largest stocks.

P/E of top 10 and remaining companies in S&P 500
Next 12 months

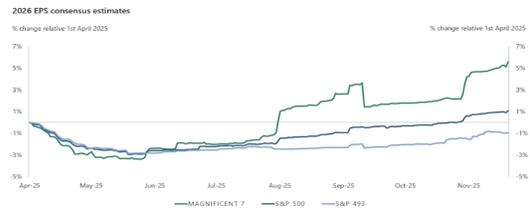


The Magnificent 7 (Alphabet (Google), Amazon, Microsoft, Nvidia, Tesla, Apple, and Meta) continue to lead the market. They have rising profit margins and earnings expectations. The SP493 (SP500 less the Mag7) is experiencing declining profit margins and earnings expectations.

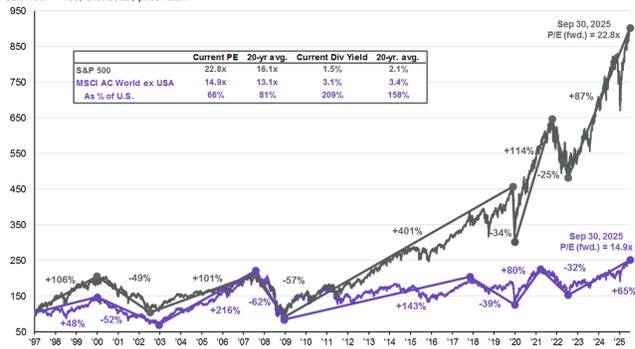
Profit Margins Rising for the S&P 7 and Declining for the S&P 493



2026 Earnings Expectations Revised up for Magnificent 7 and Down for Everyone Else



MSCI All Country World ex-U.S.A. and S&P 500 Indices
Jan. 1997 = 100, U.S. dollar, price return



The valuation in terms of Price/Earnings ratio for the S&P 500 has been higher than that for non-U.S. companies for 15 years. In the last 10 years, that gap has widened, with the discount rising from an average of 19% to 35%.

Indexing, Target Date Funds, and Retirement plan contributions will continue to be a significant tailwind for the largest U.S. stocks in 2026.

Dollar depreciation and falling oil prices

The U.S. dollar depreciated by approximately 8% in 2025. This makes American-made goods and services less expensive for foreigners and foreign-made goods and services more costly for Americans. This should reduce the trade deficit and spur economic growth in the U.S.

The price of oil fell 17.5% in 2025. Oil prices increase costs across the economy, including manufacturing and transportation. The reduction in oil prices is also a boost to the economy.

Headwinds:

Trade and Tariff uncertainty

Trade and Tariff policy has been dynamic, to say the least, for much of 2025, and this is expected to continue into 2026. This has introduced uncertainty into corporate decision-making, contributing to the slower hiring and potentially impeding growth over time.



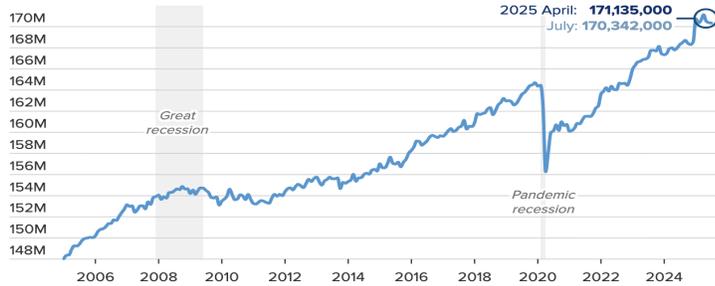
Changes in tariff rates and scope (the goods and countries subject to tariffs) have disrupted supply chains and imposed additional costs on domestic producers that rely on imported parts and components. The impact on inflation has not been significant to date, but this could change as companies assess profitability and make pricing decisions.

Immigration restrictions and skilled labor shortage

The number of native born workers in the U.S. is declining. Aging baby boomers and low birth rates will sustain that trend.

The U.S. labor force declined by nearly 800,000 workers between April and July 2025

Monthly size of U.S. labor force | Jan. 2005–July 2025



Note: Workers 16 and older, seasonally adjusted
Source: U.S. Bureau of Labor Statistics
Data as of Aug. 1, 2025



Foreign-born workers have augmented the workforce. This is changing as the Trump administration has taken several actions that have reduced the number of foreign-born workers in the country and expected to arrive in the coming years.

These steps include:

- Expanded and expedited the deportation of undocumented people
- Restrictions on asylum claims
- \$100k fee for H1B applications
- Reduction in the number of humanitarian parolees allowed

Over time, this too will slow economic growth.

Federal Reserve independence and inflation

The Federal Reserve has operated with a “dual mandate” since an amendment to the Federal Reserve Act in 1977. The dual mandate is to manage monetary policy to achieve stable prices and maximum employment. Increasing interest rates is a response to inflation (inflationary pressures), whereas decreasing interest rates to spur economic growth is a response to higher unemployment.



Current economic conditions have inflation above the Federal Reserve's 2% target and unemployment rising slightly. The Federal Reserve's ability to make independent judgments has come under pressure as policymakers seek to lower short-term interest rates to boost economic growth and reduce the cost of servicing the large and growing national debt.

While this will likely lower short-term rates, longer-term rates have been trending slightly upward, with bond investors requiring higher yields to compensate for the risk of holding longer-term bonds amid rising inflation. This includes mortgage rates. Higher, longer-term rates tend to slow economic growth.

Student loan payments are restarting

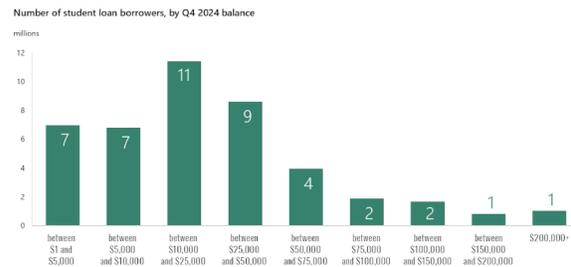
Student Loan Timeline



The government paused Student loan repayment for several years, and the pause is now over for all borrowers. The restarting of required repayments impacts 45 million people.

With a variety of non-trivial outstanding balances

Number of Student Loan Borrowers, by Balance



The Pause on Reporting Delinquent Federal Student Loans Has Ended



The delinquency rate has already spiked, along with a modest increase in delinquency rates on other types of loans.

The payments to service Student loans will reduce other spending and overall economic activity.

Elevated Large Cap Company valuations

While valuations are not reliable short-term signals for market timing, they can indicate the limits of upside and downside. They can also influence investor sentiment over time. Elevated valuations can persist for months or years.



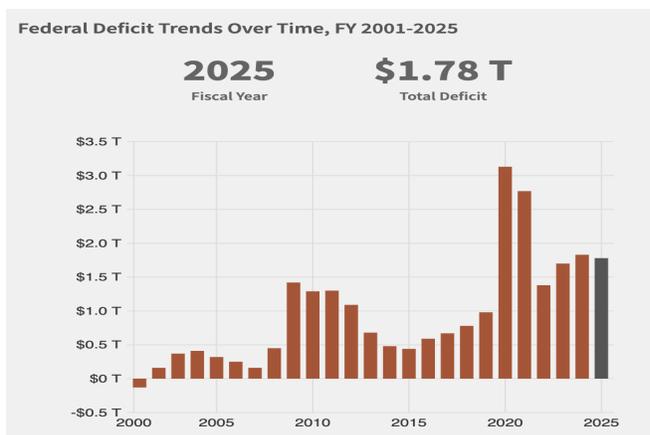
The Cyclically Adjusted Price Earnings Ratio, created by Nobel Prize-winning economist Robert Shiller, is higher than at any time in history other than the Dot-Com bubble in 1999.

The “Buffett Indicator” calculates the ratio of the Total U.S. Stock Market value to the U.S. Gross Domestic Product (GDP). This indicator is higher than at any time in history.



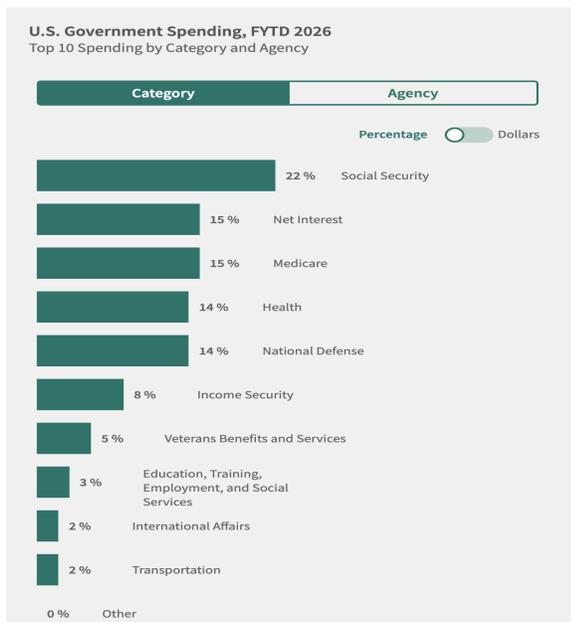
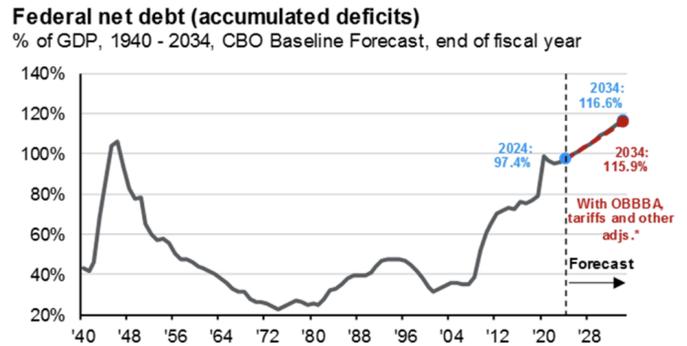
U.S. Fiscal Situation

Fiscal policy is shaped by laws enacted by Congress and the President that set spending and tax rates.



The result of the tax and spending decisions over the last 30 years has been an annual Deficit - spending more than taxes collected.

The annual deficit is increasing the National Debt, which is accelerating and on an unsustainable path.



Growing debt can crowd out other investments and require the Government to pay debt service, the second-largest spending item in the Federal budget. Money used for debt service cannot be used for social services or national defense.

At some point, a combination of spending cuts, higher taxes, or money printed (dollar devalued) will be required. None of those measures will benefit the economy.

Geopolitical risks

Conflicts in Ukraine and the Middle East, as well as tensions in many other regions, have the potential to disrupt trade and supply chains. Key products and materials like GPU chips used for AI and rare earth minerals used to create magnets, lasers, and batteries, crucial to manufacturing many commercial and military products, could potentially be disrupted.

Financial industry trends:

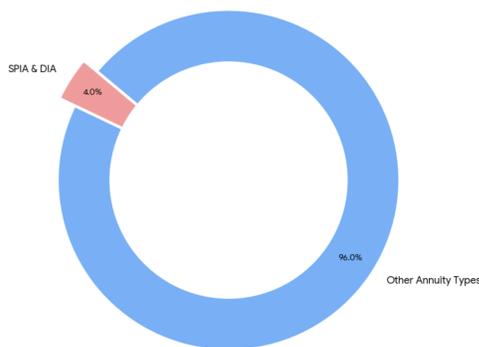
Sales of Annuities

As Baby Boomers enter and approach retirement, insurance companies continue to intensify their efforts to sell Annuities. Smarter Bear has written over the years about Annuities, and unlike advisors who over-sell Annuities and others who are 100% against Annuities, we take a more measured approach.



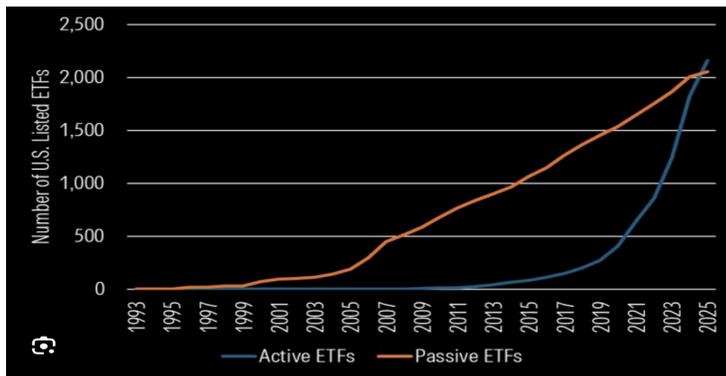
This chart shows the growth of annuity sales through 2024, with 2025 sales expected to top \$450B.

Fee-only advisors, like Smarter Bear, don't have a financial stake in recommending anything other than what is in our clients' best interest. Annuities are not a suitable investment due to high fees, limited investment options, and limited liquidity. But they can serve a purpose for some clients by providing an income stream the client cannot outlive. Income Stream Annuities are referred to as Single Premium Immediate Annuities (SPIA) or Deferred Income Annuities (DIA).



Roughly 95% of annuities are sold as investments, not income streams - SPIAs and DIAs. Advisors and insurance companies earn substantially more by selling Annuities as investments.

Many new types of Exchange Traded Funds (ETFs)



When ETFs were initially introduced in the U.S. in 1993, they were primarily passive, low-cost index funds. In recent years, the financial industry has sought ways to generate additional fee-based income and introduced a growing number of actively managed, *higher-cost* ETFs.

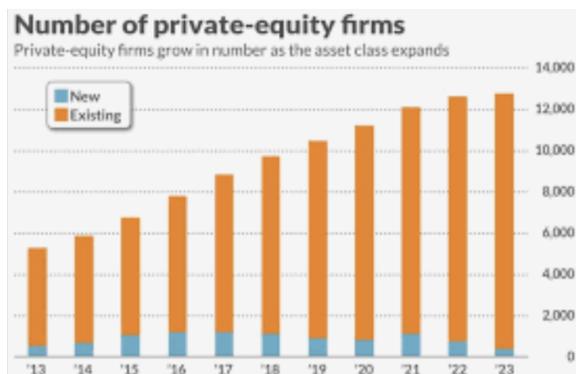
A few of the notable types of actively managed ETFs include:

- Single stock ETFs - some of which seek to amplify the gains or losses on that stock.
- Defined outcome ETFs - there are now hundreds of defined outcome ETFs that offer various parameters for limiting losses in exchange for reduced or capped upside. The underlying investment can be a basket of selected stocks, Bitcoin, or an index such as the S&P 500, the NASDAQ 100, the Russell 2000, or the MSCI EAFE. These funds may also be referred to as Hedged Equity, Buffer, or Barrier funds.
- Income-generating ETFs that use options techniques such as collars and selling covered calls to deliver targeted results.

Depending on a client's goals and circumstances, some of these funds may be a valuable part of their portfolio; however, like other highly profitable investments to their sponsors, it's a safe bet that they are oversold even when they are not the best or even an appropriate choice.

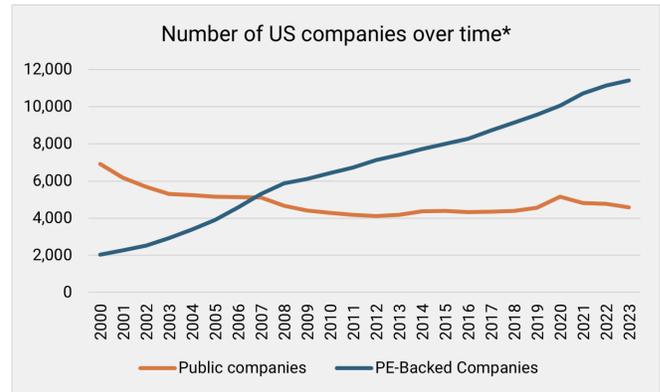
Private Equity and Private Debt offerings to the public

Private Equity is investments in companies not listed on public stock exchanges.



The number of Private Equity firms has grown over the years, and the assets they manage have grown even faster.

As a result, the number of companies owned by Private Equity firms has increased as well, often displacing the public market companies (by eliminating potential IPOs or taking public companies private through buyouts).

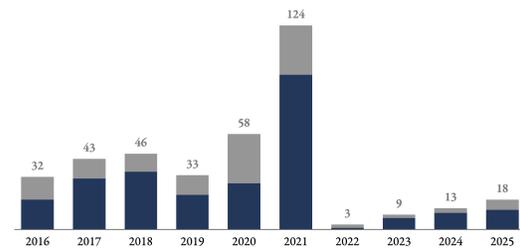


*As of June 30, 2024.

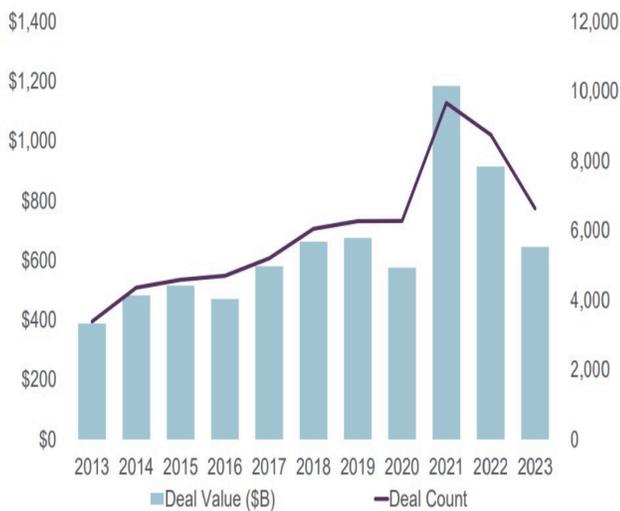
However, the number and deal size of the exits have slowed. Both in the form of Initial Public Offerings (IPOs) and deals of any type.

PE-Backed IPO Activity

By Deal Volume By Deal Value
 Jan.-Aug. Sep.-Dec.



U.S. PRIVATE EQUITY DEAL ACTIVITY



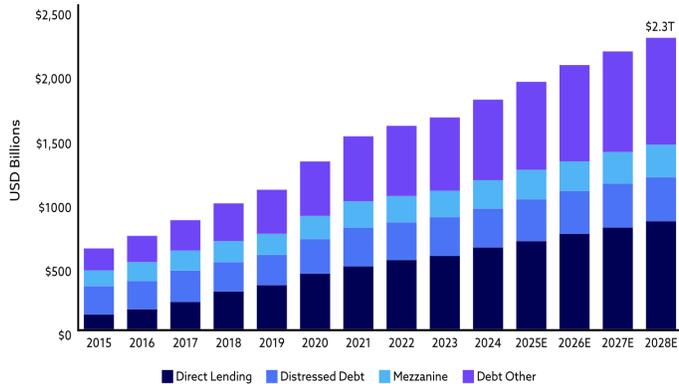
The slowdown in exits means existing investors are not receiving the expected distributions from private equity fund investments. This has several follow-on effects:

1. Existing investors are not making new Private Equity investments.
2. Private Equity firms have created "Continuation" funds to buy the "stuck" assets from themselves.
3. Private Equity firms are seeking additional Private Credit (see below).
4. Private Equity firms are looking for new types of investors. The primary target is 401(k) plans limited to mutual funds that invest in publicly traded companies and debt securities.

Smarter Bear is cautious about individual investors buying into Private Equity for several reasons:

1. High expenses
2. Limited liquidity
3. Lack of transparency
4. Perhaps most importantly, the assets offered to individual investors will be less attractive than those provided to the traditional Private Equity investors - Institutions, Pension funds, and Sovereign Wealth funds.

Growth in Private Credit by type



There are various ways to invest in Private Credit, and they are increasingly available and heavily promoted by the sponsors. Private credit is lending done outside of traditional bank lending, and bonds are sold and traded on public markets.

Private Credit is offered through:

- Business Development Companies
- ETF Interval funds
- Private Credit funds.

One of the primary selling pitches is that Private Credit is less volatile than Public credit. However, this only appears to be the case because Private Credit is not "marked to market". That means the price is not adjusted when interest rates change or the borrowers' creditworthiness changes. Private Credit is not immune to these changes; sponsors choose not to reflect them in pricing.

As with Private Equity, sponsors are seeking ways to offer Private Debt investments to retail investors through Business Development Companies and 401(k) funds. Smarter Bear recommends extreme caution.

Conclusion

So what do you do with this mixed bag of optimistic and pessimistic information? No one can accurately and consistently predict market outcomes. Smarter Bear continues to recommend diversification based on client goals and financial circumstances. When diversification is well executed, it helps a portfolio realize gains when markets are strong and protect against the worst outcomes when markets are weak.

Smarter Bear is always available for a free, no-obligation consultation to answer questions and discuss whether our services can help address your needs. We offer no-cost second opinions for DIYers or people working with another investment or financial advisor.

None of the above is intended as a substitute for investment, tax, or legal advice. Your personal situation will determine what is best for you, and we recommend that you consult an appropriate professional advisor.